No. 11,941

IN THE

United States Court of Appeals

For the Ninth Circuit

HARRY V. SOANES,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

FRANK O. BELL,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

LUTHER E. GIBSON,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

VALLEJO BUS COMPANY (a dissolved California corporation),
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITIONERS' OPENING BRIEF.

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PERNAU-WALSH PRINTING CO., SAN FRANCISCO

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STATEMENT OF JURISDICTION.

To the Honorable William Denman, Presiding Judge, and to the Honorable Associate Judges of the United States Circuit Court of Appeals for the Ninth Circuit:

On May 27, 1946, petitioner Vallejo Bus Company filed its petition with the Tax Court of the United States for a redetermination of deficiencies of its declared value excess profits tax and excess profits tax for the calendar year 1942 (R. 3). On said date petitioners Soanes, Bell and Gibson also filed their petitions with the Tax Court of the United States for a redetermination of the deficiencies and transferee liability for the calendar year 1942 of said petitioners as transferees of the assets of petitioner Vallejo Bus Company (R. 1). On January 27, 1948, the Tax Court entered its decision that there was a deficiency of $3,074.94 in decared value excess profits tax and a deficiency of $27,721.76 in excess profits tax for the calendar year 1942 for petitioner Vallejo Bus Company (R. 61). On said date the Tax Court also entered its decisions that petitioners Soanes, Bell and Gibson were liable for said deficiencies as transferees of the assets of petitioner Vallejo Bus Company (R. 58, 59, 60). These cases are brought to this Court by Petitions for Review filed April 26, 1948, in accordance with sections 1141 and 1142, Internal Revenue Code (Title 26, U. S. C.) (R. 61).

STATEMENT OF THE CASE.

These four cases involve a dissolved corporation and its three transferee stockholders. The parties hereto have stipulated that petitioners Soanes, Bell and Gibson are liable for such deficiencies of taxes of petitioner Vallejo

Bus Company for the calendar year 1942, together with interest thereon as provided by law, as may be determined in this proceeding (R. 74). The parties have further stipulated that the decision in the cases of petitioners Soanes, Bell and Gibson will be governed by the decision of this Court in the companion and controlling case of petitioner Vallejo Bus Company, since the liability asserted against the transferees is the liability of petitioner Vallejo Bus Company (R. 74). The parties have stipulated that the four cases be consolidated for briefing, arguing, hearing and decision (R. 75). Accordingly, the term "petitioner" as hereinafter used will refer solely to petitioner Vallejo Bus Company unless specific reference is made to the other petitioners.

The facts which are the same in all four proceedings were submitted upon a stipulation and exhibits which the Tax Court adopted as findings of fact (R. 50). The pertinent portions of the facts are as follows:

1. Petitioner was incorporated under the laws of the State of California on July 3, 1936. Petitioner's principal business was the operation of certain bus lines in the City of Vallejo, California, and adjoining territory. Petitioner was an active operating public utility under the jurisdiction of the Railroad Commission of the State of California, and held a certificate of necessity issued by said Commission dated May 6, 1941. During all the times hereinafter mentioned the entire issued and outstanding capital stock of petitioner was owned as follows:

Luther E. Gibson	100
Frank O. Bell	100
Harry V. Soanes	200

(R. 15, 16).

2. On or before May 19, 1942, Luther E. Gibson, Frank O. Bell and Harry V. Soanes entered into an oral partnership agreement for the purpose of acquiring and operating the bus lines then owned and operated by petitioner. The interests in the capital and profits of said partnership were as follows:

Luther E. Gibson	¼
Frank O. Bell	¼
Harry V. Soanes	½

(R. 16).

On November 12, 1942, said oral partnership agreement was reduced to writing (R. 16, 20). On May 19, 1942, said partnership, doing business under the firm name and style of Vallejo Bus Co., offered to purchase the operative rights of petitioner and all petitioner's assets except four Reo Buses for the sum of $29,937.20 (R. 16, 17).

3. At a special meeting of the Board of Directors of petitioner held on May 19, 1942, said offer of said partnership was accepted (R. 17). At said special meeting a resolution was voted and unanimously approved, which read in part as follows:

> "Be it resolved: That the offer made to this Corporation by Luther E. Gibson, Harry V. Soanes and Frank O. Bell, Co-Partners doing business under the firm name and style of The Vallejo Bus Co. to purchase the operative rights of the Corporation and all of the assets of the Corporation save and except four Reo Busses * * * for the sum of $29937.20 be and the same is hereby accepted; and that the sale and transfer of said operative rights and assets be effective as of the 1st day of June, 1942, subject to the approval of the Railroad Commission of the State of California, * * *" (R. 24, 25).

4. Said partnership opened a bank account on June 1, 1942, in the name of Vallejo Bus Co., a partnership, and all receipts and revenues from the operation of said business on and after that date were deposited in said bank account (R. 17).

5. On or about June 11, 1942, endorsements were requested with respect to all policies of insurance issued to petitioner naming as assured on said policies Luther E. Gibson, Harry V. Soanes and Frank O. Bell, doing business as Vallejo Bus Co. Said endorsements were made by the insurers and were effective on or before June 11, 1942 (R. 17).

6. Petitioner and said partnership entered into an agreement dated June 9, 1942 (R. 17). Said agreement was "* * * by and between Vallejo Bus Company, a corporation, as Seller, and Luther E. Gibson, Harry V. Soanes and Frank O. Bell, co-partners doing business under the firm name and style of Vallejo Bus Co., as Buyers; * * *" (R. 26). Said agreement provided in part as follows:

> "That said Seller agrees to sell unto said Buyers and said Buyers agree to buy of and from said Seller, the following described personal property, to wit:
>
> "Being the following busses, to wit:
>
> [Here was listed 18 vehicles.]
>
> "Also, all machinery, tools and equipment, furniture and fixtures, transportation equipment including coin boxes, all business fixtures and improvements to the premises from which the business of said Seller is operated, together with materials and supplies therein contained, and prepaid insur-

ance; also all franchises and operating rights of the said Seller.

"TO HAVE AND TO HOLD the same unto said Buyers for the sum of TWENTY-NINE THOUSAND NINE HUNDRED THIRTY-SEVEN and 20/100 ($29,937.20) DOLLARS, in lawful money of the United States of America, receipt of which is hereby acknowledged by the said Seller.

"IT IS UNDERSTOOD AND AGREED that the sale of said personal property herein above described shall be effective as of June 1, 1942, but that same is subject to the approval of the Railroad Commission of the State of California and in the event said approval is not forthcoming, this agreement will be null and void and of no effect, * * *" (R. 26, 27).

Said agreement of June 9, 1942, reduced to writing the offer and acceptance made by petitioner and the partnership on May 19, 1942 (Cf. R. 23, 26).

7. On June 9, 1942, petitioner filed a petition with the Railroad Commission of the State of California requesting the Commission to approve the sale and transfer of its assets (R. 17, 18). A copy of petitioner's written agreement of June 9, 1942, was attached to said petition to the Railroad Commission (R. 28, 30). On September 15, 1942, said Commission issued its order granting the application of petitioner and authorizing the transfer of the properties described in said agreement of June 9, 1942 (R. 18, 33).

8. On February 4, 1943, an investigation into the reasonableness of the fares of Vallejo Bus Co., the partnership, was instituted by the Commission on its own motion

after a preliminary survey of the situation and recommendation by the staff. Public hearings were held in Vallejo on March 3, 1943, and March 10, 1943 (R. 35). At said hearings a report was presented by the Commission's Transportation Research Engineer and said report was considered by the Commission along with the rest of the evidence in reaching its decision concerning a reasonable rate (R. 35, 36). Said report read in part as follows:

> "On June 1, 1941, Luther E. Gibson, Harry B. [V.] Soanes, and Frank O. Bell, acquired the corporate stock of the Vallejo Bus Company and took over the management. On June 19, 1942, Vallejo Bus Company (a corporation) filed Application No. 25072 to sell its operative rights and property to the Vallejo Bus Company, a partnership consisting of Mr. Gibson, Mr. Soanes, and Mr. Bell. The present proportion of ownership, we understand, is as follows: Soanes, 50 per cent; Gibson, 25 per cent; and Bell, 25 per cent. This application was granted under Decision No. 35777, dated September 15, 1942." (R. 47).

Said report also contained the following language concerning the Federal income tax allowable as an expense in computing a reasonable rate:

> "*Income Tax*
>
> Income taxes computed herein are based on the actual type of organization of the company. In other words, the first five months of 1942, are computed on a corporation basis and remaining months are on a partnership basis." (R. 48).

On March 23, 1943, the Commission rendered its decision setting a reasonable rate (R. 42, 43). Said decision contained the following finding of fact:

"Since June 1, 1941, the company has been owned by Luther E. Gibson, President, Harry B. [V.] Soanes, Vice President, and Frank O. Bell, Manager, having control relationships of 25 per cent, 50 per cent, and 25 per cent, respectively. The company operated as a corporation until June 1, 1942, after which time it became a partnership." (R. 37).

9. Petitioner was dissolved on December 31, 1942. Petitioner filed its income tax return for the calendar year 1942 with the Collector of Internal Revenue for the First District of California and reported therein income from the operation of said bus lines for the period January 1, 1942, to May 31, 1942. Said partnership filed its income tax return with the Collector of Internal Revenue for the First District of California and reported therein income from the operation of said bus lines for the period June 1, 1942, to December 31, 1942. The Commissioner has taxed to petitioner income from the operation of said bus lines for the period June 1, 1942, to September 15, 1942. The only issue in controversy is whether the Commissioner erred in making this adjustment (R. 18, 19). The Commissioner is asserting said adjustment solely because the Railroad Commission did not issue its order approving the transfer of petitioner's business until September 15, 1942.

QUESTION FOR DECISION.

The sole question at issue in these consolidated cases may be stated as follows:

Where a corporation operating a public utility subject to the jurisdiction of the Railroad Commission of the State of California enters into an agreement prior to June 1, 1942, to take effect on that date, to sell the business to a partnership composed of its stockholders, subject to the approval of said Commission, and where the transfer is made on June 1, 1942, and where the properties are operated by the partnership on and after June 1, 1942, must the income from the business for the period June 1, 1942, to September 15, 1942, be taxed to the corporation solely because the Commission did not issue its order approving the transfer until September 15, 1942?

STATEMENT OF POINTS RELIED UPON.

1. The Tax Court of the United States erred in deciding that the sale and transfer of petitioner's business was ineffective between the parties thereto, under the law of the State of California, until the Railroad Commission of the State of California issued its order on September 15, 1942 (R. 65).

2. The Tax Court of the United States erred in deciding that the sale and transfer of petitioner's business was ineffective, under the law of the State of California, to render the revenues of the business taxable to the partnership until the Railroad Commission of the State of California issued its order on September 15, 1942 (R. 65).

3. The Tax Court of the United States erred in deciding that the sale and transfer of petitioner's business was ineffective, as between the parties thereto, under the terms and conditions of the contract of sale and under petitioner's resolution authorizing said contract, until approval by the Railroad Commission of the State of California was obtained on September 15, 1942 (R. 65).

4. The Tax Court of the United States erred in deciding that the sale and transfer of petitioner's business was ineffective, under the terms and conditions of the contract of sale and under petitioner's resolution authorizing said contract, to render the revenues of the business taxable to the partnership until approval by the Railroad Commission of the State of California was obtained on September 15, 1942 (R. 65).

5. The Tax Court of the United States erred in failing to consider that the Railroad Commission of the State of California, in its decision dated March 23, 1943, fixing the rates to be charged by the partnership, found as a fact that the bus business had been operated as a partnership since June 1, 1942, and that in computing a fair rate of return said Railroad Commission took into consideration the return realized during the calendar year 1942, which return was computed by allowing as a deduction corporate income taxes for the period January 1, 1942, to May 31, 1942, and individual income taxes of the partners for the period June 1, 1942, to December 31, 1942, which individual taxes were computed on the assumption that the partners had no other source of income. In fixing said fair rate of return, said Railroad Commission considered facts contained in its own engineer's report, which re-

port noted on its face that said Railroad Commission's order approving the sale and transfer of petitioner's bus business had not been issued by said Railroad Commission until September 15, 1942 (R. 65, 66).

6. The Tax Court of the United States erred in failing to decide that the receipt of income by the partnership from the operation of the bus business between June 1, 1942, and September 15, 1942, under a claim of right and without restriction as to its disposition, had the legal effect of making such income taxable to the partnership and hence not taxable to petitioner (R. 66).

7. The Tax Court of the United States erred in deciding that possession of the income from the operation of the bus business for the period June 1, 1942, to September 15, 1942, by the partnership was possession by said partnership as agent of petitioner and that hence petitioner remained the lawful owner of the income until September 15, 1942 (R. 67).

SUMMARY OF ARGUMENT.

I. The date on which the Railroad Commission promulgated its approval of said sale and transfer is not material in determining the effective date of said sale and transfer.

II. As an additional argument petitioner contends that the income for the period in question cannot be taxed to the petitioner but must be taxed to the partnership because said income on and after June 1, 1942, was received by said partnership under a claim of right and without restriction as to its disposition.

ARGUMENT.

I.

THE DATE ON WHICH THE RAILROAD COMMISSION PROMULGATED ITS APPROVAL OF SAID SALE AND TRANSFER IS NOT MATERIAL IN DETERMINING THE EFFECTIVE DATE OF SAID SALE AND TRANSFER.

Concerning points 1, 2 and 5 relied upon by petitioner (set forth herein at pages 9-10), petitioner shows as follows:

Petitioner's principal business was the operation of certain bus lines in the City of Vallejo, California, and adjoining territory. Petitioner was an active operating public utility under the jurisdiction of the Railroad Commission of the State of California (R. 16) and subject to the Public Utilities Act of said State. Because petitioner was subject to the Public Utilities Act respondent concludes that petitioner's otherwise valid sale and transfer of June 1, 1942, was a nullity as between the parties and of no effect whatsoever until said nullity was vitalized by the approval of the Railroad Commission on September 15, 1942.

In this connection respondent relies upon Sections 50¼ and 51(a) of the Public Utilities Act of California, 6386, the pertinent parts of which are as follows:

> "§ 50¼. Operation of Passenger Stages: * * * Any right, privilege, franchise or permit held, owned, or obtained by any passenger stage corporation may be sold, assigned, leased, mortgaged, transferred, inherited, or otherwise encumbered as other property, only upon authorization by the Railroad Commission. * * *" (Added by Stats. 1927, p. 74.)
>
> "§ 51. Selling, Leasing, etc., of Public Utilities: * * * (a) No public utility shall henceforth sell, * * *

> or otherwise dispose of or encumber the whole or any part of its * * * plant, system, or other property necessary or useful in the performance of its duties to the public, or any franchise or permit or any right thereunder, * * * with out first having secured from the railroad commission an order authorizing it so to do. Every such sale, lease, assignment, * * * made other than in accordance with the order of the commission authorizing the same shall be void. * * *'' (Stats. 1915, p. 115.)

Because of the foregoing provisions of the Public Utilities Act requiring the approval of sales by the Railroad Commission, particularly the provisions of Section 51(a) providing that a sale made other than in accordance with an order of the Commission is void, respondent has apparently concluded that the sale and transfer of June 1, 1942, was a nullity *as between the parties* until the approval of the Railroad Commission on September 15, 1942. The respondent apparently further concludes that during this period of time the income must therefore be taxed to the vendor although it was actually received and retained by the vendees. It is petitioner's contention that the sale of June 1, 1942, was valid on that date *as between the parties thereto* since the Railroad Commission had no authority concerning this sale other than its statutory authority to veto the sale if it should be found contrary to the interests of the public. It was so held by the Supreme Court of California in the leading case of *Hanlon v. Eshelman*, 169 Cal. 200, 202; 146 Pac. 656 (1915), in which the Court defined the Commission's power as follows:

> "* * * *The commission's power is to be exercised for the protection of the rights of the public interested in the service, and to that end alone.* * * * With the rights of an intending purchaser the commission has nothing to do. Nor has it power to determine whether a valid contract of sale exists, or whether either party has a legal claim against the other under such contract. These are questions for the courts, and not for the railroad commission, which is merely authorized to prevent an owner of a public utility from disposing of it where such disposition would not safeguard the interests of the public. * * *" (Italics added.)

See also the case of *Sale v. Railroad Commission,* 15 Cal. (2d) 612, 620; 104 Pac. (2d) 38 (1940), in which the Supreme Court of California has lately affirmed and restated the principle of *Hanlon v. Eshleman,* supra, quoted above. It seems clear, therefore, that Sections 50¼ and 51(a) of the Public Utilities Act, as consistently interpreted by the Supreme Court of California, do not go so far as to divest a public utility of its entire power of sale, but merely give to the Railroad Commission the power to invalidate a sale found to be contrary to the public interest. Moreover, the principle stated in *Hanlon v. Eshleman,* supra, and the corollary which follows therefrom are in accordance with the rule, stated in 23 Am. Jur., *Franchises,* Section 36, concerning the unauthorized transfer of a public utility franchise:

> "Generally, an unauthorized transfer of a public utility franchise is no ipso facto void; *on the contrary, the transfer will be treated ordinarily, as valid and effectual* until attacked by the sovereign grantor

in a direct proceeding instituted for the purpose. * * *'' (Italics added.)

It follows, therefore, that a particular sale by a public utility is *not void in its entirety* prior to approval, and the parties thereto can create valid rights and liabilities *as between each other,* subject only to a subsequent disapproval in the public interest.

There appear to be no California cases in which the validity of an unauthorized sale by a public utility has been directly in issue. However, the Supreme Court of North Dakota has passed squarely upon this point, and has ruled that a sale by a public utility of all its assets was valid and enforceable prior to approval by the Railroad Commission of said state. This case is cited as good authority for the same proposition under California law since the applicable section of the North Dakota Public Utilities Act is practically identical with Section 51(a) of the California Act.

The North Dakota case referred to is *Otter Tail Power Co. v. Clark,* 59 N. D. 320; 229 N. W. 915 (1930). In this case defendant was the owner of a power company which he sold to plaintiff in 1925. Plaintiff then leased the company back to defendant. Neither plaintiff nor defendant obtained the approval of the Railroad Commission for this sale of a public utility, which permission was required by the Public Utilities Act of North Dakota. To facilitate comparison, the pertinent parts of Section 51(a) of the California Public Utilities Act are repeated below alongside the applicable portion of the Public Utilities Act of North Dakota:

Public Utilities Act of North Dakota.

"No public utility shall hereafter sell * * * or otherwise dispose of * * * its franchise, works or system, necessary or useful in the performance of its duties to the public * * * without first having secured from the Commissioners an order authorizing it to do so. Every such sale * * * made, other than in accordance with the order of the Commissioners authorizing the same. shall be void." Laws 1919, C. 192, § 21, section 4609 C. 21 Supplement.

Public Utilities Act of California.

"No public utility shall henceforth sell, * * * or otherwise dispose of * * * the whole or any part of its * * * plant, system, or other property necessary or useful in the performance of its duties to the public, or any franchise or permit or any right thereunder, * * * without first having secured from the railroad commission an order authorizing it so to do. Every such sale, * * * made other than in accordance with the order of the commission authorizing the same shall be void."

In 1927 defendant went out of possession and plaintiff took possession of the system. About this time plaintiff decided to sell the system to a third party, but could not do so since plaintiff had never received permission to purchase the system. Defendant refused to join with plaintiff in an application to the Railroad Commission of North Dakota to approve the sale.

Plaintiff, as vendee of the original sale, and in his own name, then petitioned the Railroad Commission to approve the sale made in 1925. The Railroad Commission *dismissed* plaintiff's petition on the grounds first that the vendor had not joined in the application, and second that plaintiff sought the *ratification of a completed sale and transfer.*

Plaintiff then instituted the present suit in equity and prayed that defendant be required to join in an applica-

tion to the Railroad Commission for approval of the sale. The trial court entered judgment for plaintiff and ruled *that plaintiff was the owner of the property in question as against the defendant,* subject only to such rights and limitations as the public may have *and assert.* The trial court further ordered that defendant be restrained from interfering with plaintiff's possession. On appeal, the Supreme Court of North Dakota affirmed the judgment in its entirety, although *at no time had the sale been authorized by the Railroad Commission.* Moreover, in its opinion the court cited and quoted at length from the California case of *Hanlon v. Eshleman,* supra, as correctly stating the extent of the powers of the Railroad Commission of North Dakota.

This North Dakota case stands for the principle that as between the purchaser and seller of a public utility, the purchaser is the owner of the property even though the sale did not receive the approval of the Railroad Commission as provided by statute. Accordingly, under authority of the *Otter Tail Power Co.* case, supra, petitioner concludes that the sale from the Vallejo Bus Company to the partnership was valid as between the parties on and after June 1, 1942. The subsequent approval of the Railroad Commission merely ratified the sale as not being contrary to the interests of the public.

The aforesaid conclusion receives further support in an officially reported decision of the Railroad Commission of California itself, *In re Vallejo Bus Co.,* 44 C.R.C. 627 (1943). During the year 1943 the Commission rendered its decision in a case to establish new rates for the partnership herein. The Commission, on its own motion, made

an investigation into the reasonableness of the rates being charged by the partnership. A public hearing was held, at which an extensive report concerning the operation of the bus lines was presented by the Commission's own Transportation Research Engineer. A copy of this report was admitted into evidence by the Tax Court as "Petitioner's Exhibit No. 2" (R. 44). The Commission considered this report along with other evidence in rendering its aforesaid decision as to a reasonable rate. A copy of this decision was admitted into evidence by the Tax Court as "Petitioner's Exhibit No. 1" (R. 35). Petitioner contends that said decision and report are material in ascertaining the effect of the Commission's order of September 15, 1942, since they clearly show the interpretation placed by the Commission itself upon the effect of its order upon the sale in question herein.

The Engineer's report contains the following pertinent statements:

> "On June 1, 1941, Luther E. Gibson, Harry B. [V.] Soanes, and Frank O. Bell acquired the corporate stock of the Vallejo Bus Company and took over the management. On June 19, 1942, Vallejo Bus Company (a corporation) filed Application No. 25072 to sell its operative rights and property to the Vallejo Bus Company, a partnership consisting of Mr. Gibson, Mr. Soanes, and Mr. Bell. The present proportion of ownership, we understand, is as follows: Soanes, 50 per cent; Gibson, 25 per cent; and Bell, 25 per cent. This application was granted under Decision No. 35777, dated September 15, 1942." (R. 47).

After thus specifically pointing out that the application was not granted until September 15, 1942, the Engineer,

nevertheless, makes the following statement with respect to the amount of income taxes allowable as an expense in computing a reasonable rate:

> "*Income Tax*
>
> Income taxes computed herein are based on the actual type of organization of the company. *In other words, the first five months of 1942, are computed on a corporation basis and remaining months are on a partnership basis.*" (R. 48; italics added).

The report contains a schedule showing the amount of income taxes allowed as an expense and this same schedule is repeated in the Commission's decision (R. 39). It is thus apparent that the Commission in determining the amount of income taxes allowable as expense, calculated the tax for the first five months, to June 1, 1942, on the corporate basis and for the balance of the year on the partnership basis. Moreover, the Commission's decision contains the following finding of fact:

> "Since June 1, 1941, the company has been owned by Luther E. Gibson, President, Harry B. [V.] Soanes, Vice President, and Frank O. Bell, Manager, having control relationships of 25 per cent, 50 per cent, and 25 per cent, respectively. *The Company operated as a corporation until June 1, 1942, after which time it became a partnership.*" (R. 37; italics added.)

The *Otter Tail Power Co.* case, supra, follows and applies the principle stated in *American Jurisprudence,* supra, that prior to approval or disapproval of the Railroad Commission a sale of a public utility is valid and legally binding *as between the parties thereto* under the

Public Utilities Act of North Dakota. Moreover, the *Vallejo* rate case, supra, applies this principle to the transaction in question herein. The governing statutes for the *Otter Tail* transaction and for the Vallejo Bus transaction are virtually identical. Therefore, as between the parties, this transaction must be effective, under the law of the State of California, on June 1, 1942, the date on which the bargain was struck.

Concerning points 3 and 4 relied upon by petitioner (set forth herein at page 19), petitioner shows as follows:

A conclusion different from that noted above could be reached only if the parties to the Vallejo Bus transaction had intended the sale to be effective as of some other date. However, the following examination of the facts in the Vallejo Bus transaction clearly establishes that the parties *intended* the sale and transfer to be effective as of June 1, 1942 and that the necessary documents were drawn up accordingly. Prior to June 1, 1942, to wit, on May 19, 1942, petitioner's three stockholders formed a partnership for the *specific purpose* of acquiring and operating the bus lines on and after June 1, 1942 (R. 16). Moreover, on May 19, 1942, said partnership offered to purchase, and petitioner agreed to sell the assets in question for a specified sum (R. 16, 17). At that time it was definitely stated that said sale and transfer was to be effective on June 1, 1942, subject to the approval of the Railroad Commission, and this was noted in the minutes of petitioner's directors' meeting (R. 24, 25). On June 1, 1942, the parties to the sales contract completed *substantial performance* of said contract. The partnership opened a bank account in its own name and *all the receipts and*

revenues from the operation of said bus lines were deposited therein (R. 17). It should be noted that *all* the receipts were thus received by the partnership and none by the petitioner. It is evident therefore that on said date the partnership took possession and began operating *all* of the assets of said bus lines. On June 11, 1942, endorsements were requested with respect to all policies of insurance issued to petitioner naming as assured on said policies the partnership and partners. Said endorsements were duly made and were effective on or before said date (R. 17).

Prior thereto, and on June 9, 1942, the parties jointly executed a petition to the Railroad Commission, requesting approval of said sale (R. 17, 18, 28). The details of said sale were set out in writing and said writing was attached as an exhibit to said petition (R. 26, 28). Said exhibit set out the same terms and conditions for said sale and transfer as were agreed upon between the parties on May 19, 1942, and as had then been noted in the minutes of petitioner's directors' meeting. Said writing also provided for the leasing of petitioner's unsold assets to said partnership (R. 27). Among the terms and conditions reiterated in said writing, the following is here emphasized: "* * * that the sale of said personal property hereinabove described *shall be effective as of June 1, 1942* but that same is subject to the approval of the Railroad Commission * * * *and in the event said approval is not forthcoming,* the agreement will be null and void and of no effect, * * *." (R. 27; italics added.)

It is apparent from the foregoing facts and from the quoted portion of the sales contract that the transfer

became effective on June 1, 1942, and that said transfer was *intended* to be valid and binding, and remain valid and binding as to *all* its terms, until such future time as the Railroad Commission *might* invalidate said sale.

A contract with similar terms was interpreted accordingly in the case of *Boston American League Baseball Club,* 3 B. T. A. 149 (1925). In 1919 Boston agreed to sell Babe Ruth to the Yankees for $100,000.00. The contract stated that in the event Ruth did *not* report to the Yankees on or before July 1, 1920, the Yankees had the option to cancel the contract. The whole transaction was governed by the rules of the National Base Ball Commission. Rule 28 stated, in part, that in the event a purchased player did *not* duly report to the purchasing club "the agreement * * * shall be *null and void* * * *," and the seller shall return the purchase price to the buyer. (Italics added.) The $100,000.00 was paid to Boston in 1919 and Ruth duly reported to the Yankees in 1920. Boston contended that the $100,000.00 was not income until 1920 since if Ruth did not duly report, the contract was *null and void.* The Board of Tax Appeals held, however, that the income was realized in 1919 since the contract of sale was *valid when made* and remained valid until such time as it might be cancelled.

As it happened in the Vallejo Bus transaction, the Railroad Commission not only failed to invalidate the sale, but within the same taxable year, to-wit, on September 15, 1942, signified its approval of said sale *in its entirety* (R. 33). Hence, as in the *Boston American League* case, supra, *the invalidating condition never occurred,* the

transfer remained in full force and effect, and the income received prior to approval is taxable to the recipients.

From all of the facts noted above, it is clear that there was a valid sale and transfer to the partnership effective on June 1, 1942, since not only did the parties *intend* the sale to be effective as of said date, but there was *substantial performance on said date* and the remaining performance was thereafter promptly carried out. Under such circumstances the income belonged to the partnership on and after the date of substantial performance, and this Circuit Court of Appeals has so decided in a similar income tax case, *Seattle Renton Lumber Company v. United States,* 135 F. (2d) 989 (1943). In this case (as in the Vallejo Bus transaction) a partnership of the lumber company's stockholders was organized to take over said company's assets and business. At a stockholders' meeting on June 30, 1933, the company deeded its real property to one of the partners as trustee for the partnership, and executed a bill of sale of its personal property to the partnership. After said date the business was operated by the partnership, bank accounts were opened by the partnership, and the name on the mill, trucks, and letterheads was changed to that of the partnership. *No formal articles of partnership were drawn up nor certificate of assumed name filed. The deed, declaration of trust and bill of sale were not recorded.* This Circuit Court considered that formal articles, a certificate of assumed name, and recording of the various documents were not essential to there being *a completed transaction for income tax purposes*, as of June 30, 1933. In reversing the District Court, this Circuit Court stated at page 991:

"It was shown without dispute that the shareholders were in complete agreement on the matter of discontinuing the corporate operation of the business. * * * In fairness we ought not to close our eyes to the *prior understanding and subsequent conduct* of this small and closely integrated group * * *.

"The corporation divested itself of its tangible assets and did not thereafter operate the business. * * * and there is no pretense that these people acted otherwise than in entire good faith. They were entitled to weigh the advantages of the corporate operation as against its disadvantages taxwise, and to choose the alternative partnership method of holding title to the mill property and of carrying on their business affairs." (Italics added.)

From an examination of all the facts in the Vallejo Bus transaction it is apparent that the parties *intended* the sale and transfer to be effective on June 1, 1942, that they *completed substantial performance* on said date, and that the lines were *operated* by the partnership on and after said date. It is concluded, therefore, upon authority of the *Seattle Renton Lumber Company* case, supra, that the income from the bus lines upon completion of substantial performance of the Vallejo Bus transfer *must be* taxed to the partnership and cannot be taxed to the petitioner.

II.

AS AN ADDITIONAL ARGUMENT PETITIONER CONTENDS THAT THE INCOME FOR THE PERIOD IN QUESTION CANNOT BE TAXED TO THE PETITIONER BUT MUST BE TAXED TO THE PARTNERSHIP BECAUSE SAID INCOME ON AND AFTER JUNE 1, 1942, WAS RECEIVED BY SAID PARTNERSHIP UNDER A CLAIM OF RIGHT AND WITHOUT RESTRICTION AS TO ITS DISPOSITION.

Concerning points 6 and 7 relied upon by petitioner (set forth herein at page 11), petitioner shows as follows:

Petitioner's additional argument is based upon the principle set forth by the Supreme Court in the case of *North American Oil Consolidated v. Burnet,* 286 U. S. 417 (1932). This case involved the taxability of the receipts from oil properties to which the government claimed title but which had been released to the company by the receiver. The litigation over the title to the property was not terminated until the year after that in which the properties were distributed. Nevertheless, the Supreme Court held that the company must return the income for the year in which it was received, notwithstanding the fact that the pendency of the litigation rendered doubtful the ultimate right to retain the properties which produced the income. In so holding, the Court stated at page 424:

> "If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is *required to return,* even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent." (Italics added.)

This principle has recently been restated, enlarged and clarified by the Supreme Court in the case of *Commis-*

sioner of Internal Revenue v. Wilcox, 327 U. S. 404 (1946). In this case the Court held that embezzled funds were not income since they could not have been received under a claim of right, and, moreover, under the laws of the state in which the embezzlement occurred, the wrongdoer never obtained title and was at all times liable for the restoration of the funds. In reaching its decision the Court at page 408 restated the principle of the *North American Oil* case, supra, as follows:

> "For present purposes, however, it is enough to note that a taxable gain is conditioned upon (1) the presence of a claim of right to the alleged gain and (2) the *absence of a definite, unconditional obligation to repay or return* that which would otherwise constitute a gain." (Italics added.)

Under this latest definition of taxable income there appear to be two essentials: (1) Receipt under a claim of right, and (2) *any* chance that the recipient will be able to retain the receipts.

There is no dispute that the partnership *actually received the income* in question since all receipts and revenues on and after June 1, 1942, were deposited in the partnership's own bank account (R. 17). Moreover, the facts as stipulated are replete in establishing that the revenues were *received under a bona fide claim of right.* Finally, there is nothing whatsoever in the record to indicate that the partnership was under a *"definite unconditional obligation to repay"* the revenues received, or that the partnership received the revenues as agent of the petitioner. It is manifest, therefore, that the latest defi-

nition of the Supreme Court to determine taxability is abundantly satisfied.

Moreover, this principle has been applied by the Circuit Court of Appeals for the Second Circuit in a case involving the receipt of revenue in a transaction having many of the features essential to the matter at issue herein. In the case of *Jacobs v. Hoey,* 136 F. (2d) 954 (1943), cert. den. 320 U. S. 790, five executors of an estate agreed with each other in writing that, *subject to the approval of the Surrogate,* Jacobs would receive 2% for his commission as executor. In 1936 Jacobs was paid $20,000 on account and in 1937 $19,500 on account, each of which sums he reported as income in the year paid. The law of New York as established by its courts is to the effect that an executor *cannot take commissions* for the management of an estate until they are allowed by the court. The requisite approval *was not received until 1938.* Jacobs filed claims for refunds of 1936 and 1937 income taxes due to the inclusion of the advances, claiming that they were loans rather than payments for his services. The District Court held against Jacobs and this decision was affirmed by the Circuit Court of Appeals which stated:

> "Moreover it has been generally held that such payments received under claim of right, and where the likelihood of not retaining them is slight, are a part of 'gross income' * * *."

It should be noted that in the *Wilcox* case, supra, the Supreme Court has enlarged the doctrine so that the

recipient under claim of right is taxable so long as there is *any* likelihood that he will be able to retain the income.

The most recent application of the *Wilcox* doctrine is by the Circuit Court of Appeals for the Fifth Circuit in the case of *Akers v. Scofield,* 167 F. (2d) 718 (1948). In this case Akers obtained money by false pretenses from a wealthy Texas widow during the years 1932, 1933 and 1936. Under the law of Texas, the widow could have sued and recovered this money any time prior to September, 1938. The government assessed and collected a tax against Akers on the theory that he had received the income under a claim of right and this assessment was upheld by the Circuit Court of Appeals. The court distinguished this situation from the embezzlement in the *Wilcox* case, supra, since there the recipient received no title to the money, whereas here under the law of Texas the recipient obtained title even though it was through the use of false pretenses.

The *Akers* case, supra, establishes that there is a claim of right so long as the recipient got legal title to the property even though he was knowingly obtaining possession by false pretenses. Moreover, since there was a slight chance that he might not have to refund the money received, the second essential of the *Wilcox* doctrine was satisfied. Surely if a swindler such as Akers had a "claim of right" sufficient to make the income taxable to him, how much stronger must be the claim of right of the Vallejo Bus partners who operated a legitimate business to the best of their ability and who had done all they could to comply with the law. Moreover, at all times in

the *Akers* case, supra, Akers was plainly subject to a lawsuit which would have divested him of the funds received, whereas in the instant case the petitioner had no cause of action against the partnership for a return of the funds in question. Furthermore, the record is utterly devoid of any evidence from which it could be presumed that the partnership received the revenues as agent of the petitioner.

Finally, in the *North American Oil,* the *Akers,* and the *Jacobs* cases, supra, the uncertainty as to whether the recipient would have to repay the sums received was not resolved until *after* the close of the taxable year. However, in the Vallejo Bus transaction the approval of the Railroad Commission was received *within the taxable year.* Consequently, prior to the close of said year there was *no chance whatsoever* that the partnership would have to repay the revenues which it had received. It is concluded, therefore, that under the doctrine as restated and enlarged by the Supreme Court in the *Wilcox* case, supra, and applied in the *Akers* case, supra, the income in question *must be* taxed to the partnership and cannot, therefore, be taxed to the petitioner.

CONCLUSION.

For the foregoing reasons petitioner contends that the revenues from the bus lines on and after June 1, 1942, were taxable income of the partnership under section 22(a) of the Internal Revenue Code and were not taxable income of the petitioner. Petitioner asserts that the fore-

going establishes the points relied upon by petitioner in its petition for review by this Court. Therefore, petitioner respectfully submits that the decision of the Tax Court of the United States should be reversed.

Dated, San Francisco, California,
September 7, 1948.

Respectfully submitted,
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